foreign affiliates to compete in the U.S. market. Yet, as shown above, the misconduct hypothesized by AT&T has never even been alleged to have occurred, is increasingly unlikely to occur in the future, and would be readily detected if engaged in by a U.S. reseller with a foreign affiliate.

In addition, application of the proposed condition would unjustifiably discriminate against foreign-affiliated U.S. carriers, in probable violation of U.S. MFN and NT obligations. If implemented in the same way as the benchmark conditions imposed on facilities-based authorizations, the switched resale condition would require foreign-affiliated resellers, existing or prospective, to meet benchmark settlement rates no later than 90 days after the effective date of the rules adopted in this proceeding (probably by April 1, 1998). Other providers offering the identical service on the same routes would have up to five years to meet those benchmark conditions, depending on the economic development status of the destination country. There is no basis for this discrimination against foreign-affiliated providers in comparison to others, whether U.S.-based or foreign, who do not face this accelerated compliance schedule.

Accordingly, the FCC must analyze the WTO implications of AT&T's proposal as part of its application of the public interest standard. In doing so, the Commission must recognize that the failure of the U.S. to comply with its international obligations may prompt other countries to restrict the entry of U.S. carriers into their markets, thereby further reducing competition in the market for international services.

V. AT&T'S PROPOSED RESALE SECTION 214 CONDITION WOULD CONSTITUTE AN UNAUTHORIZED TAKING.

The rights inherent in the Section 214 authorizations held by CWI are private property interests protected by the Fifth Amendment's prohibition of governmental taking without just compensation. The courts have held that governmental licenses to pursue lines of business qualify as "private property" for the purposes of the taking clause of the Fifth Amendment.[43/]

In determining whether a federal agency action qualifies as a "taking" forbidden by the Fifth Amendment the Supreme Court has primarily relied on *ad hoc* factual inquiries into the circumstances of each case. *Connolly v. Pension Benefit Guaranty Corp.*, 475 U.S. 211 (1986) ("*Connolly*"). Three factors are of particular significance: (i) the economic impact of the regulation on the claimant; (ii) the extent to which the regulation has interfered with distinct investment-backed expectations; and (iii) the character of the government action.[44/] In the instant case, these factors considered in combination or alone demonstrate that the FCC's imposition of foreign carrier settlement rate benchmarks on CWI's Section 214 authorizations for international resale would be a taking under the Fifth Amendment.

43/ *See, e.g., Jackson v. United States*, 103 F.Supp. 1019 (Ct. Cl. 1952) (federal government abrogation of state commercial fishing license); *see also Shanbaum v. United States*, 1 Cl. Ct. 177 (1982), *aff'd* 723 F.2d 69 (Fed. Cir. 1982) (loss of Title III broadcasting license could justify takings claim); *see also Beach Television Partners*, 38 F.3d 535 (11th Cir. 1994); *Orange Park Florida T.V., Inc. v. FCC*, 811 F.2d 664, 674 n.19 (D.C. Cir. 1987).

44/ *Id.* at 224-25; *see also Atlas Corp. v. United States*, 895 F.2d 745, 756-757 (Fed. Cir. 1990); *United States v. One (1) 1979 Cadillac Coupe de Ville*, 833 F.2d 994, 1000 (Fed. Cir. 1987); *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978) ("*Penn Central*"). Any single factor may be determinative as to whether there has been a taking. *See, e.g., Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1005 (1984).

The economic impact of the contemplated action alone would be sufficient to demonstrate a taking.[45] There is no question that the economic impact of the regulation on CWI would be severe. CWI has expended hundreds of millions of dollars investing in switching equipment, transmission facilities, and U.S. employees to develop a profitable carrier business, as well as the significant resources required to prepare and prosecute all necessary state and federal licenses, including dozens of Section 214 applications. Moreover, CWI has also expended significant start-up and operational costs required to offer international service. CWI has paid regulatory fees imposed by the FCC and will be assessed for mandatory Universal Service Fund contributions.

It is worth noting that the FCC has found each country to be a separate market, and therefore each route constitutes a separate line of business for CWI. Adopting the resale Section 214 condition would effectively terminate approximately 30 lines of business currently pursued by CWI, compromise CWI's ability to be a full service carrier, waste CWI's significant investment in providing international resale, and deprive CWI of the profits it would have reaped under its current Section 214 authorizations.[46] The adverse economic

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[45] In *United Nuclear Corp. v. United States*, 912 F.2d 1432 (Fed. Cir. 1990)("*United*"), the court found that there had been a taking when, due to prolonged inaction by the Department of the Interior, valuable mining leases expired without the claimant being able to begin mining. When reviewing the economic impact of the Interior Department's failure to act, the court found it significant that the claimant had expended approximately $5.3 million in securing the leases and exploration of the leasehold for uranium. *Id.* at 1435. The court found that the profits the claimant would have realized if it had been permitted to mine the leased land to be part of the economic impact of the Interior Department's action. *Id.* at 1435-1436.

[46] An agency action that is a taking must: (1) take property for a public use; and (2) provide for just compensation. In this matter, the character of the FCC's action is to take for public use, but not to provide just compensation. The FCC would effectively revoke CWI's resale Section 214 authority on approximately 30 routes in the (misguided) belief

(continued...)

impact of these actions to CWI, considered in the aggregate or individually, would be significant.

Adoption of a resale Section 214 condition also would drastically alter CWI's investment-backed expectations without just compensation, thereby constituting an unlawful taking under the Fifth Amendment.[47] CWI has invested many tens of millions of dollars in establishing an international telecommunications business. A significant aspect of CWI's business is its ability to resell international service. CWI entered into this business in the United States and secured the necessary Section 214 authorizations from the FCC with the reasonable expectation that it could use those authorizations to establish its business profitably.

In *NRG Co. v. United States*, 24 Cl. Ct. 51, 62 (1991)("*NRG*"), in determining that the claimant was due compensation for the taking of mineral license rights, the court stated:

> [T]he government chose to modify the established rules after the pertinent agreements were entered. It certainly was not reasonably foreseeable at the time the instant permits were signed that the government would enact legislation cancelling them.

As such, it is not relevant if the FCC generally has authority to modify Section 214 authorizations. Rather, the issue for a claim of taking is whether CWI reasonably could have anticipated that the FCC would modify its Section 214 authorizations in such a manner as to destroy its ability to continue to provide international resale on particular routes. Under the

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[46](...continued)
that such action would prevent predatory pricing conduct to the detriment of competitive conditions in the U.S. market. The requirement of "public use" in the context of takings is interpreted so broadly that public use is "coterminous with the scope of a sovereign's police powers." *Hawaii Hous. Auth. v. Midkiff*, 467 U.S. 229, 240 (1984) ("*Midkiff*"). Therefore, Section 214 modifications constitute a public use.

[47] *See United* at 1437.

circumstances here, CWI could not reasonably have anticipated the adoption of the proposed condition, which accordingly constitutes an unlawful taking regardless the FCC's authority to modify Section 214 authorizations.

The FCC does not have the statutory authority to modify CWI's Section 214 authorizations as proposed.[48] Courts narrowly construe the statute based upon their ability to identify a class of cases in which the regulation would constitute a taking.[49] Applying the strict test of statutory construction, an FCC action modifying CWI's Section 214 authorizations would be unlawful because there is no expressed or necessarily implied statutory authority to effect such a taking.[50] To avoid having to compensate each of the carriers in the class, a court may find that the FCC did not have the authority to effect such

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[48] In *Bell Atlantic Tel. Cos. v. FCC*, 24 F.3d 1441 (D.C. Cir. 1994) ("*Bell Atlantic*"), the Court of Appeals found that the FCC did not have the authority to require physical collocation. The court determined that even though the FCC had authority to require physical connections under Section 201 of the Communications Act of 1934, as amended (the "Act"), because there was no expressed or necessarily implied authority to order physical collocation in the Act, the FCC did not have the authority to order physical collocation. *Id.* at 1447. The *Bell Atlantic* case is reflective of a trend in successful takings claims. *See Dolan v. City of Tigard*, 114 S.Ct. 2309 (1994); *Lucas v. South Carolina Coastal Council*, 112 S.Ct. 2886 (1992); and *Nollan v. California Coastal Comm'n*, 483 U.S. 825 (1987).

[49] In *Bell Atlantic* the Court of Appeals ruled that "[w]ithin the bounds of fair interpretation, statutes will be construed to defeat administrative orders that raise substantial constitutional questions." *Bell Atlantic* at 1445; *see also United States v. Security Indus. Bank*, 459 U.S. 70, 82 (1982) ("*Security Industrial*"), *distinguished United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128 n.5 (1985) ("*Riverside*"). Although the actions being reviewed under the factually sensitive standards of *Penn Central* may not be subject to the same narrow construction, it should be emphasized that the takings issue was not properly before that court. *Bell Atlantic* at 1444, n. 1. and 1446. Being unable to rule on the issue of takings, the court nevertheless found that because the Act cannot be read to authorize the FCC to effect an uncompensated taking, the FCC did not have that authority.

[50] A narrow construction of the Act is appropriate to avoid a taking of the rights held by international resale carriers that are affiliated with foreign carriers.

a taking under the Act. Here, FCC action modifying CWI's Section 214 authorizations will amount to a taking and no provision for just compensation to CWI has been made. As the Act does not authorize the FCC to effect uncompensated takings, the FCC does not have the authority under the Act to modify CWI's Section 214 authorizations in a manner that takes CWI's business.

VI. NOTICE OF THE POSSIBLE ADOPTION OF THE RESALE SECTION 214 CONDITION WAS, AS A MATTER OF LAW, INADEQUATE.

The *Foreign Participation Notice* contained no suggestion that the Commission was considering imposing conditions on any Section 214 resale authorizations. Instead, the *Notice* made clear that the FCC intended to "impose specific and significant sanctions on foreign-affiliated carriers *that engage in* anticompetitive conduct in the U.S. market."[51] Moreover, AT&T's comments only suggest requiring compliance with the benchmark settlement rates as a condition of resale Section 214 authorizations *granted on or after December 19, 1996* to U.S. carriers with foreign affiliates.[52] The Commission specifically took note of AT&T's point in the *Settlement Rate Decision* and observed that the issue would be better addressed in this proceeding, stating that "parties will have an opportunity to comment in their reply comments" in this proceeding.[53] In fact, however, parties did *not* have an opportunity to reply to AT&T's comment in light of the *Settlement Rate Decision*, because

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[51] *Foreign Participation Notice*, ¶ 81 (emphasis added). As noted above, the Notice made clear that the Commission "continue[s] to believe that the resale of international switched services . . . does not present a substantial possibility of anticompetitive conduct in the U.S. international services market." *Id.*, ¶ 31.

[52] *See* AT&T Comments at 33, n.60 and 46.

[53] *See Settlement Rates Decision*, ¶ 230.

that order was not released until August 18, 1997, several days *after* the reply comment period closed in this proceeding.[54] More importantly, the C&W companies had no reason to respond to AT&T's comment because AT&T clearly sought conditions on *new*, not existing, Section 214 authorizations. Since CWI holds existing resale authorizations, the AT&T proposal would not apply to these authorizations. The need for adequate notice is even more critical in situations where the FCC's action constitutes a "taking."

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[54] The filing of the *ex parte* statement by the C&W companies on October 10, 1997, does not remedy the Commission's notice problem. The fact that one party files comments does not mean that all relevant parties have notice. *See MCI Telecomm. Corp. v. FCC*, 57 F.3rd 1136, 1141 (D.C. Cir. 1995); *American Fed'n of Labor v. Donovan*, 757 F.2d 330, 339-340 (D.C. Cir. 1985).

VII. CONCLUSION

For the reasons discussed above, the Commission should not adopt the proposal to condition existing Section 214 resale authorizations of foreign-affiliated U.S. carriers on acceptance of benchmark settlement rates. Adoption of such a condition would have a devastating impact on U.S. consumers by depriving them of competitive international resale services, contrary to the public interest and the open market principles of the WTO Agreement.

Respectfully submitted,

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October 31, 1997

Before the
Federal Communications Commission
Washington, DC 20554

In the Matter of	)	
	)	
Rules and Policies on	)	IB-Docket
Foreign Participation in	)	No. 97-142
the U.S. Telecommunications Market	)	

Statement of Larry F. Darby
Darby Associates -- Washington, DC

Submitted to Accompany Supplemental Comments
of
Cable & Wireless, PLC
and
Cable & Wireless, Inc.

October 27, 1997

Statement of Dr. Larry F. Darby

I. Qualifications

My name is Larry F. Darby. I am an economic and financial analyst specializing for the past twenty years in matters related to the evolution of telecommunications technology, markets and public policy. I head Darby Associates, a consulting practice in Washington, DC. I am Professorial Lecturer in Telecommunications Finance at the George Washington University Graduate School and contributing editor to Communications, Business and Finance for which I write biweekly articles under the banner, "Investment Notes". I have previously served as Assistant Professor of Economics -- Graduate School of Business, Temple University; Senior Economist in the White House Office of Telecommunications Policy; Chief of the Economics Division and Chief of the Federal Communications Commission Common Carrier Bureau; and, Vice-President of Corporate Finance in Lehman Brothers Telecommunications Investment Banking Group. I earned a PhD in Economics from Indiana University. My professional interests and activities are focused on the intersection of telecommunications network economics, finance and public policy.

II. Purpose of Paper

I have been asked to review claims provided on behalf of AT&T by Dr. William H. Lehr on matters related to regulatory conditions of entry and competition in US markets for international telecommunications services. Below, I will state and critique the core of Dr. Lehr's analysis. In particular I will contest the basis for his conclusion that the Federal Communications Commission should, as a matter of competition policy and in furtherance of consumer welfare, erect financial barriers to entry into U.S. markets and thereby protect incumbent carriers from entry and competition from firms with foreign affiliates.

III. The Case for Raising Regulatory Barriers to Entry

Dr. Lehr has undertaken a difficult task.[1] He attempts to show that a US policy of

[1] For purposes of this statement I have reviewed two documents submitted by Professor Lehr: Affidavit of William H. Lehr on Behalf of AT&T Corp., July 7, 1997, and attached to comments of AT&T in IB-Docket No. 97-142; In the Matter of Rules and Policies on Foreign Participation in the U.S. Telecommunications Market (hereinafter, Lehr

protecting consumers and encouraging competition in markets for US international telecommunications services is best served by raising costs to potential entrants and erecting thereby significant regulatory and financial barriers to new competitive entry. He attempts to show that consumers are made worse off as a result of substantial rate reductions occasioned by new competitive entry; he concludes that the way to preserve competition is to limit the number of competitors; he urges creation of artificial and quite likely insurmountable barriers to entry for an important class of potential new entrants; and, he recommends imposing regulatory constraints on the intensity of rivalry in markets that the Commission has recently found to be less than fully and adequately competitive.

The core of Dr. Lehr's argument is: a) settlement rates abroad exceed economic costs; b) foreign-affiliated carriers will use the surplus to "subsidize" US consumers and to "squeeze" US carriers; c) this consumer "subsidy" and carrier "squeeze" harms the competitive process in US markets; and, therefore, d) the FCC should prevent US based, foreign-affiliated carriers from offering lower rates and more choices to US customers until the FCC finds that their rates pass a burdensome FCC cost-of-service test.

Dr. Lehr concludes that US consumers should be denied the benefits of competition from US based, foreign-affiliated telecommunications carriers. While supporting the principle of competition, he recommends adoption of rules that would effectively protect incumbents from an important source of competition by preventing foreign-affiliated carriers from entering markets for international telecommunications services in the US, unless and until they meet a vague, burdensome and discriminatory cost of service test.

IV. Summary and Conclusions

A substantial burden is borne by advocates of the creation of regulatory barriers to entry

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Affidavit); and, a memorandum to the FCC International Bureau from William H. Lehr on behalf of AT&T; August 4, 1997 (hereinafter, Lehr Memorandum) for new competitors as a means of advancing economic welfare, promoting competition and insuring sustainable competitive processes in markets for telecommunications services. The recommendation flies in the face of most conventional economic analysis. Even though some circumstances may justify adoption by government of regulatory proscriptions on entry, the case is difficult to make and the rationales for doing so are of limited applicability.

The case for not limiting entry is straightforward and indisputable. Consumers are made better off immediately by rate reductions and the increased choice that necessarily accompanies new competitive entry. To show that they are made worse off and to justify foreclosing or discouraging entry requires a showing that a) some subsequent harm is assured to be visited on consumers or some other dimension of the public's welfare, and b) that the harm is sufficient to offset the initial gains in welfare. Lehr concedes that consumers are made better off immediately by the increased choice and lower rates afforded by entrants, but he fails to establish and quantify -- as required -- substantial, offsetting, downstream economic harm to consumers or the broader public interest from increased competition to AT&T and other US international carriers.

Dr. Lehr's conclusions are based on a weak and unsupportable analytical foundation and the policy he recommends will diminish, rather than increase, competition and consumer welfare. To elaborate, I will address below the following points:

- The analysis is entirely hypothetical and relies on market suppositions that are clearly contradicted by practical and theoretical considerations;
- The reasoning is tautological -- true by virtue of its logical form -- and, therefore, without economic content or policy relevance;
- New entry will increase consumer welfare by increasing rate competition and increasing consumer choice;
- The basis for competition policy distinguishes potential harm

to incumbent firms from harm to competitive processes and recognizes that creating benefits for consumers is "harmful to competitors";

- There is no need here to protect competitors in order to foster competition;
- Imposing cost of service regulation for foreign-affiliated carriers raises rivals costs and raises entry barriers without creating value for US consumers;

V. Analysis

Dr. Lehr correctly states and supports, in principle, the core of the case for promoting competition as a means of advancing the public interest:

> Competition benefits consumers by encouraging lower prices, improved quality and expanded customer choice. Protecting and promoting competition provides the surest way for policy makers to benefit consumers.[2]

However, the remainder of the paper is remarkably inconsistent with this straightforward support of competitive processes common among economists.

To justify an exception to the general rule that entry and intensified competition will enhance economic welfare, Dr. Lehr attempts to prove that entry from new foreign-affiliated entrants into US markets for international telecommunications services will harm US "competitive processes". He neither alleges, nor establishes, harm to consumers; nor to economic welfare; nor, to the broader public interest. The harm alleged is to incumbent carriers in the US international services market. The protection he recommends will benefit competitors, not consumers.

The Lehr argument for the Commission to erect regulatory barriers to entry and to

[2] Lehr Affidavit, p. 5.

suppress competition from foreign-affiliated carriers is deficient in several respects.

Lehr's Argument Consists Entirely of "Illustrations" with Hypothetical Numbers and Assumed Behaviors. To support his contention that foreign-affiliated competitors will behave in ways that will harm US consumers, Dr. Lehr constructs "a simple example [to] illustrate how this could occur" (emphasis added).[3] The "Lehr Illustration" is based on numerous explicit assumptions. It displays elaborate calculations and numerical manipulations for which he neither provides nor claims any basis in fact. The Illustration incorporates hypothetical, but very specific, values for various types of incumbent charges, settlement rates abroad, costs abroad, the amount of traffic involved, the average price for an outbound call and others. The Illustration also assumes the acquisition by a foreign entity of a major US firm (10% market share of the US international services market), notwithstanding the facts of the current market structure. It assumes a constant price elasticity of demand; an investment and marketing strategy for the foreign firm or its affiliate; the pricing strategy of the entrant and the pattern of response of incumbent competitors. Change the assumptions and you change the policy conclusion. It is a simple matter to change the assumptions and mechanics of the Illustration to support a variety of contradictory policy conclusions.[4]

The implicit assumptions of Lehr's Illustration also have significant implications for the

[3] Lehr Affidavit, p. 13. It is notable that the Illustration focuses on what "could" occur; not what will occur or what might reasonably be expected to occur. There is no denying that events "could" in remote circumstances occur and there is no way to prove the negative. But, the policy case should be based on probabilities, not on possibilities. To make the illustration relevant for policy purposes, Lehr must establish that the elements of his illustration are factual or highly probable. He undertakes to do neither.

[4] Dr. Lehr elaborates and explains his assumptions in a lengthy memorandum to Commission Staff. The assumptions have direct effects on the outcome of the Illustration. To the extent that they are not, or cannot, be empirically verified, the probative value of the Illustration is weakened. See, Lehr Memorandum. For an excellent and up-to-date (contrasting) discussion of entry barriers see Stephen Martin, Advanced Industrial Economics, chapter 7, "Market Structure, Entry and Exit", (Cambridge, Massachusetts: Blackwell Publishers, 1993) and the extensive list of references cited there. The text there and references make clear that barriers to entry are difficult to rationalize on economic efficiency or consumer welfare grounds, while providing neither support nor mention of the kind of behavior hypothesized by Dr. Lehr.

analysis and for the policy case being considered. For example, Lehr implicitly assumes that a foreign-affiliated carrier could systematically, repetitively and substantially set rates that are below costs without complaint, detection or regulatory action in a US regulatory and market environment that is notable for all three. It is simply not credible to suppose that a foreign-affiliated carrier will be able to damage US consumers substantially and persistently with no response from the US government. Nor is it credible to suppose that a firm could buy capacity from an underlying carrier, then practice subcost pricing without detection. A resale carrier's costs are almost fully known by both the government and the underlying facilities carrier. While there may be some questions about the costs of an unregulated facilities-based carrier, there can be little doubt about the folly of a small reseller attempting to "squeeze" its larger, more diversified, facilities-based supplier.

Moreover, the Lehr Illustration is not an economic model in the traditional sense; nor is it an economic theory with any basis in the literature; nor is it an hypotheses that can be tested or verified empirically.[5] It is a set of numbers and assumed relationships and hypothetical behavior patterns woven together in such a way as to characterize what might occur if all the assumptions held in the marketplace and in regulatory arenas. The Lehr Illustration compares results from one assumed state of the market to the results in another assumed state of the market -- all without regard to contemporary and well known theories of market conduct under various market structures, entry conditions, corporate objectives and reaction patterns.[6]

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[5] Assumptions in economic models need not generally be descriptive in a factual sense, if the model yields good predictions. But, the Lehr Illustration is not offered as a testable hypothesis. It is a closed system of definitions, assumptions, relationships and results.

[6] Validating those assumptions and hypothesized relationships is a sizable undertaking. I believe that a more complete and reliable assessment of the incentives and behavior of firms in this market should draw more carefully on facts about current market structure, conduct and performance; as well as some reasonable consideration of contemporary economics theory and literature addressing predatory pricing, game theory in markets with few sellers of differentiated products, dynamic rivalry involving pricing, quantity and investment games, the behavior of entrants into tightly held oligopoly markets, the behavior of incumbents in response to strategic entry overtures from diversified firms, and more. These matters are completely ignored by Lehr, but routinely addressed in the literature in economic analyses of the factual case constructed in the Lehr Illustration. (For an indication of how rich and uncertain the relevant economic theory is, in contrast to the simplicity and certitude of the Lehr Illustration, see, for example, Carl Shapiro, "Theories of Oligopoly

The Lehr Illustration resembles a "simulation" models of sorts, inasmuch as it uses a system of hypothesized relationships and assumed values for key variables.[7] The outcomes of the Illustration are the direct result of the definitions, assumptions and behavioral relationships that make it up.[8]

Lehr's Assumptions Render the Illustration Unreliable for Policy Purposes. The Lehr Illustration contains a chain of logic that has several weak links. If any of the links is broken, so is the integrity of the analysis that supports FCC suppression of competition by erecting regulatory barriers as suggested by Lehr. Lehr concludes that price competition initiated by entrants who offer rates lower than those prevailing in the market is harmful to consumers and should be prevented or discouraged by the FCC. He gets to this strange conclusion by an empirically demanding chain of assumptions, definitions and logic. A statement of the chain follows:

> "...US international markets are competitive..."[9]

> "In a competitive market, the only way to lower prices

Behavior"; Janusz Ordover and Garth Saloner, "Predation, Monopolization, and Antitrust"; Richard J. Gilbert, "Mobility Barriers and the Value of Incumbency" and references there in Handbook of Industrial Organization, Richard Schmalensee and Robert Willig (eds), North Holland, volume 1.) Lehr provides one highly restricted, specifically constrained, strongly idiosyncratic analysis of the behavior of oligopolistic firms confronted by the prospect of new entry by an entrant whose motivations and goals are also tightly constrained by assumption. Lehr provides one special case and a highly unlikely one.

[7] "Simulation" is a process of representing one system by another. Simulation models extract key relationships, parameters and estimates from real world processes and configure those in ways that permit calculating the effects on the dependent variables of selected, well-defined perturbations of the underlying key causative variables or processes (i.e., the relationships between the key variables). Computer simulations represent real world systems or subsystems as a system of equations that can be solved for various specifications of the model's variables and functional relationships quickly by computer. Thus, for example, the growth of income or population or disease in the real world is often simulated by complex mathematical growth models. Many macroeconomic forecasts are the result of large, computer simulation models and account in part for the profession's forecasting reputation.

[8] As with computer simulations and simulation models more generally, the old adage holds here -- "Gold in, gold out"-- with respect to the relationships of assumptions and conclusion; of inputs and outputs; and, of specifications and results of the Lehr Illustration.

[9] Lehr Affidavit, p. 7.

is to lower costs."[10]

> "Any form of below-cost pricing is anticompetitive...and harmful to consumers."[11]

> "...a foreign entrant into the US would be unlikely to have a significant cost advantage..."[12]

No matter how you read it, any rate reduction by a foreign-affiliated entrant into the US market must be "unfair" and "harmful" to US consumers. On this basis, Lehr recommends that the prospect for any such rate reduction in the US market for international telecommunications services should be headed off by the FCC.

The structure of the logic of Lehr's argument and Illustration either proves nothing or it proves too much. It proves too much if it holds for the case he is addressing -- entry by a foreign-affiliated carrier garnering generous settlements -- since the same logic similarly condemns as anticompetitive and antithetical to US consumer interests any entrant (foreign-affiliated or not), with or without the benefit of excessive settlements) attempting to establish a foothold in the US international services by undercutting rates offered by incumbents.

Lehr's argument and Illustration address only entry by ARGMEX, an hypothetical, foreign-affiliated carrier fueled by settlements subsidies. But the logic of the Illustration would also condemn entry by a foreign-affiliated carrier from a country with no settlements subsidies to draw from or, indeed, entry by any US resale or facilities-based entity. If the argument holds for ARGMEX, it holds more generally, since the Illustration assumes that any entry based on rate reductions must be below cost or otherwise "unfair" to incumbents. The argument thus

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[10] Lehr Affidavit, p. 13.

[11] Lehr Affidavit, p. 13.

[12] Lehr Affidavit, p. 13.

condemns any new competition and supports barriers to new competition from any source.

But, in fact, the Lehr Illustration is unlikely to hold at all, even for the limited circumstances for which it is tailored. The reason is that the assumptions are simply too restrictive and do not reflect the facts of the real world.

First, while there is clearly rivalry among domestic carriers offering international services to US consumers, the quality of competition is by no means comparable to that in the economists' model of perfect competition. Nor is that market demonstrably in long run equilibrium, as defined in standard economic models. These distinctions are important for they belie Lehr's assumption that any rate reduction impelled by competitive entry will be "anticompetitive" or will "harm competitive processes". It is simply not true that current rates reflect minimal costs in any absolute or ideal sense and that any rate reduction is to be condemned without a showing of cost reductions. Again, Dr. Lehr proves too much, if he proves anything. The logic of the argument -- and its uniform application -- dictates that a rate reduction by one of the incumbents might also draw suspicion, unless it is accompanied by evidence of reduced costs.

Lehr makes the assumed connection between assumed market structure and assumed "rock bottom" cost of incumbents quite explicit at another part of the paper:

> ..evidence that US long distance markets [and US outbound international services markets] are already competitive suggests that there are no additional scale or scope or other cost savings which US carriers could avail themselves of to offset losses imposed by a price [reduction or] squeeze.[13]

In plain English, this says that incumbents are so efficient that they cannot lower costs and prices

[13] Lehr Affidavit, p. 22

to meet new competition without peril to their long term survival. Such an assertion finds no basis in theory or the behavior of incumbents in the market place. The Commission is absolutely correct that incumbents will be able to share market growth with entrants and to absorb losses of market share -- just as firms in other increasingly competitive marketplaces are expected to do.[14]

Nor does the US international services market manifest the conditions, as supposed by Lehr, of a perfectly competitive market in long run equilibrium. The Commission recognized imperfections in competition in markets for international services market at the time it declared AT&T "nondominant" in those markets. At that time, the Commission found that AT&T no longer possessed market power, but the Commission also found, according to the International Bureau Chief at the time:

> ...that the market is not fully competitive yet because of "generic structural problems". But the best long term solution to those problems is to allow both resale and facilities based competition on both ends of international routes.[15]

In return for being declared nondominant, AT&T agreed to several conditions, involving pricing and access to cables, that would offset some of its residual ability to behave anticompetitively. Lehr presents no evidence that the Commission erred or should reconsider and revise these findings and requirements at this time.

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[14] Lehr seems to be assuming that incumbents are absolutely technically and economically efficient, so that no savings are possible of any kind, from any part of operations, from any line of business. But, firms in workably competitive markets are constantly adjusting inputs and processes in response to changing market conditions. Firms operate in a dynamic environment and they respond accordingly. The Lehr view is very static and represents a state of "absolute efficiency" that is never achieved. Lehr offers no evidence to suggest that additional efficiencies are not possible and, indeed, casual empiricism clearly establishes that all the incumbents in this market are adjusting to changing market realities. The "efficiency" literature generally recognizes the presence of slack or "X-inefficiency" in imperfectly competitive firms and clearly establishes the existence of "slack" in most firms. See for example the discussion in W. Kip Viscusi, John M. Vernon and Joseph E. Harrington, Jr., Economics of Regulation and Antitrust, MIT Press, Cambridge, 2nd edition, pp. 83-4.

[15] See, TR Online May 13, 1996.

The point here is that there is no factual basis to support the assertion that AT&T or other international services providers are cost-constrained in accordance with the Lehr assumption of a perfectly competitive market in long run equilibrium with no power to control costs or adjust revenue in response to competitive market entry.

The additional assumption that a foreign-affiliated carrier would not likely have a cost advantage, and/or would not be able to initiate competition and attempt to gain market share by reducing rates is empirically unsupported and probably unsupportable in the context of the illustration used by Lehr. The Illustration commences with "...what would happen if the [foreign-affiliated] carrier bought a US carrier with a 10 percent market share."[16]

There is no obvious reason, other than the constraints imposed by the Lehr assumptions, why this hypothetical incumbent [domestic] carrier could not reasonably cut rates and benefit consumers (without running afoul of either the antitrust laws or FCC rules) before the acquisition by the foreign-affiliated carrier. Nor is there any feature of the acquisition of the domestic carrier by the foreign-affiliated one, as hypothesized by Lehr, that would invite condemnation of behavior by the new foreign-affiliated owner of what is reasonable and laudable competitive market conduct when undertaken by American firms. The Lehr analysis renders anticompetitive, behavior that in most other contexts would be, and generally is, lauded by the Commission.

Dr. Lehr wrote: "By assuming that the US market was initially at a competitive equilibrium (i.e., prices are equal to long run economic costs), I am able to infer the equilibrium wholesale and retail prices and assure that any price cut by the foreign-affiliate will be below cost." It is important to read this sentence carefully. Shorn of all pretension to science or analysis, this statement is logically equivalent to the following one : "Let's begin our analysis of the effect of new entry by foreign-affiliated carriers into US international markets by assuming such entry can only be based on predatory (below cost) pricing and is therefore bad from a policy

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[16] Lehr Affidavit, p. 14.

perspective." Thus, Lehr's principal conclusion is a mere assumption.[17] The rest is window dressing.[18]

Analysis of the Lehr Illustration makes clear that the results follow directly from the assumptions; and, that insofar as the assumptions and hypothetical behavioral relationships do not hold, neither does his recommendation to suppress competition from new entrants have a sound and reliable basis.[19] But there are other problems with the Illustration that are damaging to the case for suppressing competition.

The Lehr Proposal Might Force Some Carriers to Exit from the Market. Not only would the Lehr Proposal increase barriers to future competition, it would reduce the intensity of existing competition by requiring some current rivals to exit. Thus, the proposal provides for a double-edged diminution of both present and future competition. By imposing additional costs on some

[17] Lehr contends that "...the assumption that markets are initially at competitive equilibrium is innocuous and correctly focuses attention away from an empirical issue that is irrelevant to the underlying argument." (P. 3, Memorandum to FCC International Bureau on behalf of AT&T, August 4, 1997) I contend that the assumption is the conclusion and that the validity of the assumption is a necessary condition for the validity of all subsequent policy recommendations. He contends that the assumption does not matter. I conclude that not only does the assumption matter, it fully controls the conclusion of the analysis and the basis of the policy recommendation. In a memorandum to the FCC International Bureau prepared and submitted on behalf of AT&T, Lehr undertakes to explain why "...the simplifying assumptions made in the example do not affect the overall conclusion reached in my affidavit." My review of those assumptions and Lehr's explanation leads to a precisely opposite conclusion. The overall conclusion of the affidavit is the direct and unavoidable consequence of the assumptions made in the example used for illustrative purposes.

[18] Lehr concedes that he has not tested the assumption empirically. He offers it on the basis of a belief that "...available evidence suggests a presumption of effective competition is reasonable." (Emphasis supplied.) But the notion of effective competition is very different from the theoretical notion of competition necessary to support an assumption that current market prices are equal to costs defined and measured in such a way that any price reduction is predatory or otherwise inefficient. Lehr is in short assuming that the current performance of US international telecommunication suppliers tracks the idealized textbook model of perfect competition in which there are no frictions, all players are perfectly informed, all adjustments are instantaneous, etc., etc. To accept the analysis, we must accept the premise that incumbent international service suppliers, including AT&T, are absolutely efficient in both technical and economic senses. Otherwise, there would be opportunity for efficient entry. If it proves anything at all, Lehr's assumption proves rather too much. If it proves that any entry from foreign-affiliated carriers would "harm the competitive process", it also proves that entry from any source would be inefficient.

[19] The Lehr Illustration is a variant of a technique used by the prominent English Economist David Ricardo. Ricardo was fond of forming a new theory, buttressing it with arithmetic illustrations, then manipulating the numbers in the illustration to prove his theory. Critics objected of course and named this tautological practice -- the Ricardian Vice.

AT&T competitors, the Lehr proposal would provide for a direct transfer of wealth from US consumers to AT&T's shareholders -- a result precisely opposite to standard competition policy.

Lehr Concedes that Entry Will Immediately Increase Welfare for US Consumers. In the affidavit Dr. Lehr recognizes the salutary effect for U.S. consumers of the new consumer option and added competition afforded by the hypothetical foreign-affiliated entrant. In discussing his Illustration of the price cut initiated by the new entrant, Lehr declares that "...it appears that US consumers gain because prices... [they pay]...have fallen by $0.10." Lehr indicates further that the gains to consumers are substantial, as indicated by "the apparent static increase in consumer surplus of $108,750".[20]

The Illustration indicates that the price cuts by the new entrant will increase consumer surplus for U.S. customers, but these gains will be accompanied by losses of producer surplus by both US domestic carriers and the foreign-affiliated entrant.[21] The total loss in producer surplus is shared in substantially unequal proportions in the Illustration: 10% comes from the foreign-affiliated entity, while 90 % comes from incumbent carriers in the US market. Thus, the effect of the new entry and competition is to transfer wealth from suppliers to consumers -- precisely what competition is intended to do. Consumers are better off, while producers have less surplus. Much of the transfer of wealth will come from the foreign surplus gained from settlements posited in the Illustration. Thus, entry by foreign-affiliated firms will, according to Dr. Lehr, result in a voluntary transfer of wealth from carriers abroad to US consumers -- a result consistent with US policy goals and initiatives. [22]

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[20] Lehr Affidavit, note 24.

[21] I am summarizing here the core of the Illustration set forth by Lehr at pp. 13-15.

[22] Relative shares of loss of producer surplus will vary with the assumptions in the Illustration. Since the costs assumed are not purported by Lehr to reflect costs in the real world, the proportions should not be regarded as reflecting shares that might actually materialize following foreign-affiliate entry. If Lehr is correct in other respects, in all likelihood, the share borne by foreign carriers would be substantially more and result in even more transfer of wealth from foreign carriers to US consumers -- a result that reflects what the FCC is trying to do by establishing benchmarks and thereby

Lower prices and increased consumer surplus are precisely what expanded and intensified competition from new entrants is supposed to do: create value for consumers by adding choices in the marketplace at lower prices. But, according to Lehr, "This gain is illusory...."[23] He asserts that the gain will be offset by harms to US firms and to the "competitive process". But, the Lehr Illustration neither shows, nor discusses, how US competitive processes are harmed.[24]

Initially, the argument seems to be a variant of the well-known predatory pricing model, in which a firm strategically underprices in a market with the intent of creating monopoly power or market dominance that can subsequently provide the basis for raising prices and thereby recovering previous losses. Lehr makes clear that this is not the case. He is not concerned here about "predatory pricing".

> For this [subcost pricing by foreign-affiliated entrants] to be rationale [sic], it is not necessary to assume the foreign carrier is pursuing a traditional predation strategy (i.e., pricing below cost to drive competitors from the market and thereby establish market power which would enable prices to be set higher in the future.) The foreign carrier may seek to establish a position in long distance [sic] as a Trojan Horse to lever its market power into other less competitive sectors.[25]

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bounding settlement rates.

[23] Lehr Affidavit, p. 15.

[24] There are vague allusions to "severe harm to US industry" (Lehr Affidavit, p. 16) and "threatening the competitive process" (p. 13). But the nature and magnitude and incidence of the harm is never verified, quantified or otherwise specified in ways that would permit comparing the subsequent "harm" the benefits of new competition and rate reductions measured in terms of consumer welfare. One possible harm might be elimination of rivals with the intention of subsequently raising rates, but Lehr specifically disclaims that as a source of concern. (See discussion below.) Thus, so far as I can tell, the Lehr Illustration never elaborates or specifies the nature of the economic harm he alleges will offset the initial gain in consumer surplus.

[25] Lehr Affidavit, note 17.

Thus, Dr. Lehr's explanation for the behavior is not classic predation, but an undocumented and unexplained "Trojan Horse" strategy. Unfortunately, there is not enough information or analysis provided in the affidavit to permit evaluation of the "Trojan Horse" theory.[26] And, of course, increasing the intensity of market discipline that may "harm" incumbent competitors is what lowering entry barriers is designed to do.

Lehr Confuses Harms to Competitors; to Consumers; and, to Competitive Processes. It is important for policy purposes to distinguish harm to consumers from harm to competitors, each of which is mentioned or implicated by the Lehr analysis. More importantly, it is critical for the Commission to continue to recognize that the different policy implications of different types of "harms". Consumer welfare (and by implication harm to consumers) is the generally taken to be the figure of merit or frame of reference for measuring the effects of competition policy and regulatory policy. Competition and regulatory policies are for the most part targeted to improving welfare for consumers.

Preventing harm to individual competitors is not usually explicitly taken as a direct goal of either regulatory or competition policy. The essence of policies to promote competition is to create "harm" for incumbent competitors -- harm in the form of threat of loss of earnings and market share; pressure to reduce prices; pressure to incur costs to improve product quality or variety; and, pressure to incur costs to tailor offerings generally to the whims of users. The threat of these harms is the stick that drives and guides competitors in their efforts to win and hold market share. Creating harm and threat and uncertainty to individual producers is the very

[26] I am puzzled by the "Trojan Horse" theory. It is incompletely specified and cannot be verified without more information. At a minimum, we need to know a) what "market power" is being leveraged, b) what "less competitive sectors" are being targeted and c) how the practice creates wealth for the foreign-affiliated carrier. As the statement stands, the foreign-affiliated carrier is alleged to spend cash with no clear prospect of recovering or earning on it. The Trojan Horse described here looks like a poor investment indeed.

essence of successful competition policies. Harm to competitors is a valid policy argument if, and only if, such harm clearly translates into harm to consumers.

Dr. Lehr adds a third harm -- "harm [to] the competitive process in the US". The meaning of this phrase is not clear from the discussion. Nor is the phrase commonly used or defined explicitly in the economics literature, regulatory literature or in FCC expressions of policy goals. In the context of the Lehr analysis, it seems to be synonymous with harm to incumbent competitors. It seems to imply that entry from foreign-affiliated carriers will (in some unspecified ways) lead to less competition. But, clearly, in the first instance, new entry is likely to increase the intensity of competition and to reduce rates for US consumers. That point is conceded by Dr. Lehr.

But, the fact that equilibrium prices (charged by both incumbents and entrants) to US consumers are lowered by the increased competition is not sufficient, according to Lehr, to warrant its approval by the FCC since, "...it is clear that US carriers are harmed by this form of subsidized competition."[27] But, again it is important to emphasize that benefits to consumers is the figure of merit for judging the value of competition policies. Harm to carriers is of concern generally only to the extent that such harm translates to harm to consumers. Lehr neither establishes nor argues the existence of harm to consumers. The goal of competition policy has been and should be to protect consumers, not incumbent competitors. Lehr recommends protecting competitors without linking their protection to consumer welfare or the public interest.

The Cost of Service Test Proposed by Lehr is Arbitrary, Burdensome and Adds No Value for US Consumers. Lehr proposes that foreign-affiliated carriers meet an arbitrary cost of service test as a condition precedent to offering services to US consumers. The test proposed is either

[27] Lehr Affidavit, p. 15.